ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996	)	CC Docket No. 96-128

PETITION OF THE COLORADO PAYPHONE ASSOCIATION FOR PARTIAL RECONSIDERATION

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The Colorado Payphone Association ("CPA") hereby petitions for partial reconsideration of the *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, Third Report and Order, and Order on Reconsideration of the Second Report and Order*, FCC 99-7, released February 4, 1999 (the "*Third R&O*").

STATEMENT OF INTEREST

CPA's voting membership consists of independent payphone providers doing business in the State of Colorado. In addition, CPA has various other non-voting members, including operator service providers, equipment manufacturers and interexchange carriers ("IXCs"). CPA is dedicated to promoting and protecting the interests of the payphone industry and the public it serves.

INTRODUCTION AND SUMMARY

In the *Third R&O*, the Commission lowered for a second time the dial-around default compensation rate it originally set in September 1996, in its first order in this proceeding, *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, Report and Order*, 11 FCC Rcd 20541 (1996) (the "*First R&O*"). The rate has gone from $.35 to $.284 and now to $.24 a call. The $.35 rate set in the *First R&O* was adequate to fairly compensate payphone providers for the use of their payphones to place dial-around calls for which they otherwise would have received no revenue, particularly since it was linked to a market rate. With each subsequent order, however, the Commission has "discovered" new costs that should be omitted in calculating the dial-around compensation rate. While each newly-omitted cost only accounts for, at most, two or three cents per call, the effect of the revisions in the aggregate is staggering. Some 3,500,000,000 dial-around calls are made annually from payphones. The $.11 difference in the dial-around rate between the original $.35 rate and the $.24 rate now in effect *results in a loss of more than $380,000,000 per year in revenue for payphone providers.*[1]

With the trend toward fewer and fewer coin calls, payphone providers increasingly depend on dial-around revenue to support their payphones. It is therefore critical that the dial-around compensation amount fairly and fully compensate payphone providers. If payphone providers do not receive adequate compensation, the result will be the removal of marginal payphones. This is inconsistent with Congress's mandate in

Section 276 that the Commission "promote the widespread deployment of payphone services." 47 U.S.C. § 276(b)(1).

In the *Third R&O*, the Commission made a number of errors in calculating the dial-around compensation amount. In light of the importance of dial-around compensation, it is critical that the Commission correct those errors.

The Commission's first error is in using the AT&T model 11A payphone as the basis for its calculation of the cost of a typical payphone without a coin mechanism. The 11A is a stripped-down payphone that has fewer features and is less durable than a typical payphone. It is thus inappropriate to use the 11A as an analog for a typical payphone without a coin mechanism. The Commission instead should have based its cost calculations on the cost of a typical coinless model. Alternatively, the Commission could have taken the cost of a typical coin payphone and subtracted the cost of the coin mechanism. These approaches yield similar cost estimates ($766 for the typical coinless model, $832 for a typical coin model minus the cost of the coin mechanism).

The second error in the Commission's cost calculations is the use of an 11.25% rate of return. While an 11.25% rate of return may be correct for a dominant carrier in a regulated market, it does not come close to approaching an appropriate rate of return for payphone providers in a highly competitive market. The 11.25% rate of

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[1] This calculation is based on 2,223,000 payphones and the Commission's conservative and out-of-date estimate of 131 dial-around calls per month per payphone.

return is even less appropriate for small, growing independent payphone providers. At the very least, the Commission must use a rate of return of 18%.

The Commission's third error is that it underestimated maintenance costs by improperly excluding the cost of certain service visits. By failing to include the costs associated with service visits involving both repair work and coin collection, the Commission arrived at a maintenance cost that is off by roughly 9%.

The aggregate impact of these errors is significant. Taken together, *the three errors amount to a total of 6.1 cents per call, which translates into more than $210,000,000 per year in lost revenue for payphone providers.*[2] Correcting these errors will at least help restore the dial-around compensation amount to a level that approaches fair compensation for payphone providers.

In addition to the errors in the Commission's cost calculation methodology, the Commission made two additional errors regarding the implementation of dial-around compensation. First, the Commission decided not to require IXCs to implement targeted blocking, even though the Commission identified targeted call blocking as a necessary prerequisite for moving to the Commission's preferred, market-based approach to dial-around compensation. Second, the Commission erred by ordering a true-up for the period from October 7, 1997 to the effective date of the *Third R&O*. The Commission did so without engaging in the

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[2] This estimate assumes the use of the lower of the two cost calculations for a typical payphone without a coin mechanism ($766), an 18% rate of return, and the exclusion of the maintenance costs improperly excluded by the Commission. The total loss due to the Commission's errors increases significantly if the higher payphone cost calculation ($832) and/or higher rates of return are used.

required balancing of the equities. That balancing makes clear that the equities are not served by requiring payphone providers to refund a portion of the monies collected under the Commission's *Second R&O*, especially given the fact that the IXCs have already recovered *more than* the higher compensation amount from their customers and received subscriber 800 calls for free for four years as a result of the Commission's errors.

DISCUSSION

I. THE COMMISSION MUST CORRECT CERTAIN ERRORS IN ITS CALCULATION OF THE DIAL-AROUND COMPENSATION AMOUNT

A. The Commission Erred in Using the Model 11A as the Basis for Its Estimate of the Cost of a Typical Payphone Without a Coin Mechanism

Having decided in the *Third R&O* to abandon its prior, market-based approach for a "bottom-up" analysis of the cost of a dial-around call, the Commission decided that it should take as the basis for that calculation the cost of a payphone minus the cost of its coin mechanism. The Commission reasoned that, since the coin mechanism is not used when a dial-around call is made, it should not be included in the cost of such a call. In so concluding, the Commission rejected considerable record evidence that the cost of the coin mechanism is a joint and common cost that must be allocated to dial-around calls because the typical payphone would not exist without coin traffic and thus could not exist but for the coin mechanism.

CPA disagrees with the Commission's conclusion that the cost of the coin mechanism should be excluded from the cost of a payphone in calculating the cost of a

dial-around call, for the reasons given by APCC and others. But CPA is not challenging that determination in this proceeding at this time.

Given that the Commission has adopted an analysis based on the cost of a payphone minus the cost of its coin mechanism, it is imperative that the Commission follow a reasonable approach in calculating that cost. In the *Third R&O*, the Commission decided to approximate the cost of a payphone with the coin mechanism removed by using a stripped-down coinless payphone, the model 11A, as an analog. *Third R&O*, ¶ 169. This methodology is theoretically unsound and results in a drastic underestimation of the cost of the payphone. Instead, the Commission should base its estimate on the cost of the average coinless model. Using data supplied by AT&T, that cost is $766. Alternatively, the Commission could calculate the cost of a typical payphone without a coin mechanism by starting with a typical smart coin payphone and subtracting the cost of the coin mechanism. This yields a cost of roughly $832, which is relatively consistent with the $766 figure.

1. The 11A Is Not a Reasonable Analog for the Cost of the Typical Payphone Minus the Cost of the Coin Mechanism

The Commission first attempted to estimate the cost of a typical payphone without a coin mechanism in *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, Second Report and Order*, 13 FCC Rcd 1778 (1997) (the "*Second R&O*"). In basing its estimate on the cost of a 11A-type coinless payphone, the Commission relied solely on AT&T's *Second R&O* comments. *See Second R&O*, ¶ 53. In those comments, AT&T asserted that its

cost of $200-$250 for the 11A coinless unit is typical. *See* AT&T *Second R&O* Comments (August 26, 1977), Affidavit of David Robinson, 3. The Commission waved aside data submitted by the RBOC/GTE/SNET Payphone Coalition ("RBOC Coalition") demonstrating that the costs of coinless and coin payphone models were very similar and that "[o]ther parties have presented information to the effect that a coin mechanism by itself would cost less than $100." *Second R&O*, ¶ 53 n.136. The Commission chose to ignore that data, concluding without explanation that "the best information is the current prices of comparable telephones with and without coin mechanisms and that the [AT&T] data is most suitable for this comparison." *Id.*

In the *Third R&O*, the Commission affirmed without any analysis its use of the 11A as the basis for its cost calculations. Instead, the Commission relied on its previous finding in the *Second R&O* and concluded that a "typical coinless payphone without a coin mechanism is similar to the 11A-type payphone." *Third R&O*, ¶ 159. The Commission further concluded that it was proper to use the cost of the 11A-type payphone as the basis for its new bottom-up cost calculation. *Id.* Using the midrange of AT&T's $200-$250 cost estimate, the Commission thus found that the cost of a typical payphone without a coin mechanism was $225. *Id.*, ¶ 169.

The flaw in the Commission's approach is that the 11A is not a typical payphone. Instead, the 11A model is an inexpensive, bottom-end unit with few features designed for indoor locations where even coinless calling traffic is not heavy. The typical payphone, by contrast, is designed for the high-traffic sites, or for use outdoors. RBOC

Coalition Petition for Reconsideration (December 1, 1997), 12. The 11A also lacks the advanced feature set typical of smart payphones.

The RBOC Coalition raised this point in its challenge of the use of the 11A in its petition for reconsideration of the *Second R&O*. The RBOC Coalition explained that "the AT&T 11A is not an appropriate benchmark for the cost of a coinless phone of otherwise comparable durability and functionality to a typical coin phone. The 11A payphone housing is made of less durable materials than a typical coin phone." RBOC Coalition Petition for Reconsideration (December 1, 1997), 12. The RBOC Coalition went on to explain that the differences between a typical coin model and the 11A were not "merely—or even primarily—because of the need to reinforce a coin phone coin box to prevent theft. Instead, it is because the 11A is intended for use indoors . . . . The phones are simply not designed to stand up to the elements." *Id.* (citation omitted). In support, the RBOC Coalition noted that of the coinless payphone models deployed by its members "that are similar to the 11A . . . nearly 93% are located indoors." *Id.* The RBOC Coalition also noted that its members "report that the useful life for a coinless set similar to the 11A is approximately 7 years," *id.* at 13, as opposed to the 10-year life of the typical payphone assumed by the Commission. *See Second R&O*, ¶ 53 n.139. This underscores that the 11A is less durable than the typical payphone.

The RBOC Coalition also pointed out that the 11A lacks many of the features found in the typical smart payphone. According to the RBOC Coalition, "[t]he 11A lacks many functions that smart sets can perform; for example, smart sets can be

programmed far more flexibly, and are able to perform self-diagnostics that the 11A cannot perform." RBOC Coalition Reply to Oppositions to Its Petition for Reconsideration (Jan. 20, 1998), 9.

The Commission ignored the RBOC Coalition's arguments, noting that "AT&T states that it has operated the 11A-type payphone in outdoor locations for many years and that it has a useful life of 10 years." *Third R&O*, ¶ 159. The Commission therefore concluded that "based on AT&T's evidence and our own expertise, the 11A-type payphone would be materially similar to the coinless payphones that PSPs would purchase today." *Id.* The Commission did so without so much as citing—much less addressing the merits of—the RBOC Coalition's petition for reconsideration. That failure to consider record evidence constitutes reversible error. *See Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 851 (D.C. Cir. 1970), *cert. denied*, 403 U.S. 923 (1971).

In light of the RBOC Coalition's showing that the 11A is both less durable and less fully-featured than typical coinless payphones, the Commission should reconsider its determination that the 11A is "materially similar to the coinless payphones that PSPs would purchase today," *Third R&O*, ¶ 159. This is especially the case given that the 11A is not even typical of the coinless payphones operated by AT&T. As discussed further below, AT&T's 5,500 11A-type payphones constitute only one-third of the coinless payphones deployed by AT&T.

2. The Commission Must at Least Base Its Cost Analysis on a Coinless Payphone Similar to the Typical Payphone in Functionality and Durability

Rather than base its estimate on the stripped-down 11A model, the Commission should at least look to the cost of a more typical coinless payphone as the basis for its calculation. The best available evidence concerning the distribution of various types of coinless payphones is the data submitted by AT&T in its *Second R&O* comments. According to AT&T, it operates some 11,000 card-type coinless payphones in addition to the 5,500 model 11A-type payphones. AT&T *Second R&O* Comments (Aug. 26, 1997), Affidavit of David Robinson, Appendix 1, 1.

As the RBOC Coalition pointed out, Frost & Sullivan estimates the cost of card-type payphones at $941. RBOC Coalition *Second R&O* Reply Comments (Sept. 9, 1997), Arthur Andersen Reply Study, 6 (citing Frost & Sullivan, U.S. Payphone Markets (Mar. 1997), page 6-6.). Using AT&T's weighted average of AT&T's coinless set mix (5,500 11A and 11,000 card-type), the cost of a typical coinless payphone is $766.

3. As an Alternative, the Commission Should Base Its Cost Calculation on the Cost of a Typical Payphone Minus the Cost of the Coin Mechanism

As another alternative to using the 11A as an analog for the cost of a typical payphone without the coin mechanism, the Commission could base its cost calculation on the actual cost of a typical coin payphone, and subtract from that cost the costs associated with the coin mechanism. This approach makes sense in that the vast

majority of the installed base of payphones are coin models.[3] By taking as the basis for its calculations the typical installed payphone and subtracting the costs associated with the coin mechanism, the Commission can arrive at an accurate, "real world" calculation of costs.

The first step in this analysis is determining the cost of a typical payphone. In doing so, the Commission should look to the cost data supplied by Peoples Telephone Company ("Peoples") and Davel Communications, Inc. ("Davel"). The Commission used that data in adding the remainder of the costs of a payphone unit to the cost of the 11A. *See Third R&O*, ¶ 169 n.359. It is therefore appropriate to use Peoples' and Davel's data for the cost of the payphone station itself. The data from Peoples and Davel also has the advantage of reflecting cost information for smart payphone units. It would not make sense to base cost estimates on a dumb phone because those units lack both self-diagnostic functions and the ability to record call data that is critical for dial-around call tracking.[4]

Davel's cost for a payphone is $1,021, and Peoples' is $1,050. *See* APCC *ex parte* letter from Robert Aldrich to Magalie Roman Salas (Aug. 21, 1998) (reporting

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[3] *See* APCC *ex parte* letter from Robert Aldrich to Magalie Roman Salas (Aug. 21, 1998) ("coinless payphones account for a very small fraction (substantially less than 5%) of [Peoples Telephone Company's] new and existing payphone locations"); RBOC Coalition *Second R&O* Reply Comments (Sept. 9, 1997), Arthur Andersen Study, 5. ("Coinless payphones account for a very small portion of the total payphone base. Specifically, only 1.6% of all Coalition payphones are coinless and an even smaller portion are of the type (11A) used by AT&T in [its] coinless payphone cost study.").

[4] Where dumb phones are used by the RBOCs, these functions are performed in the network. Unless the Commission wishes to assign a portion of the RBOC's network

Peoples' average cost per payphone of $1,050); APCC *ex parte* letter from Robert Aldrich to Magalie Roman Salas (Sept. 16, 1998) (reporting Davel's average cost per payphone of $1,021). The average of these two cost estimates is $1,035.

The cost figures provided to the Commission by AT&T support a cost figure in this range. According to the manager of AT&T's payphone placement operations, "the average outlay associated with a new smart coin telephone [is] $1,050 for the instrument." *Second R&O*, ¶ 105 (citing AT&T *Second R&O* Comments (Aug. 26, 1997), Affidavit of David Robinson, 5). That $1,050 average figure was based on a range of smart payphone costs of $900-$1,200. *Id.* at 3.

The second step in the analysis is to determine the cost of the coin mechanism. In its petition for reconsideration of the *Second R&O*, the RBOC Coalition used three separate methodologies to estimate the coin mechanism cost, yielding cost figures of $276, $105, and $229. RBOC Coalition Petition for Reconsideration (Dec. 1, 1997), Arthur Andersen Study, 7-8. The average of those estimates is $203. This estimate, however, may be too high. The Commission itself, in the *Second R&O*, cited a study that "show[s] that the average costs of coin and coinless telephones [are] similar." *Second R&O*, ¶ 53 n.136. The Commission also noted that "[o]ther parties have presented information to the effect that a coin mechanism by itself would cost less than $100."[5] *Id.*

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costs to the costs of the payphone, the Commission can only properly capture those costs by using a smart phone as the basis for its calculations.

[5] The Commission noted that a "stronger, theftproof housing is also required if a coin mechanism is to be included." *Second R&O*, ¶ 53 n.136. Given that most

Subtracting the $203 estimate for the cost of the coin mechanism from the $1,035 price of the typical coin payphone yields a figure of $832 for the cost of a typical payphone without a coin mechanism. This figure is similar to the $766 figure for the cost of a typical coinless payphone.

B. The 11.25% Rate of Return Used by the Commission Drastically Understates the Cost of Capital for a Typical Payphone Service Provider

The Commission's second error in calculating the dial-around compensation amount is its use of an 11.25% rate of return. *See Third R&O*, ¶ 169. The Commission first adopted the use of an 11.25% rate of return in the *Second R&O*. There, it found that "most payphones are owned by large local exchange carriers, whose authorized interstate rate of return has been 11.25% representing a weighted average of debt and equity costs." *Second R&O*, ¶ 60. The Commission therefore concluded that "11.25% is the appropriate cost of capital for payphone providers in this context." *Id.*

The flaw in the Commission's conclusion is that, as a result of its orders in this proceeding, the RBOCs' payphone operations have at least allegedly been removed from the RBOCs' regulated operations. To the extent that the Commission has been successful in implementing Congress's mandate to end the RBOCs' subsidization and discrimination in favor of their own payphone operations, *see* 47 U.S.C. § 276(a)(1), the RBOCs' payphone operations are being operated as stand-alone business units. Thus,

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payphones are built to be durable enough to withstand weather conditions, abuse, and regular wear and tear, the additional costs necessary to "theftproof" the coin housing are likely minimal.

the RBOC payphone operations should have access to capital at rates similar to independent payphone providers.[6]

Independent payphone providers do not enjoy access to capital on nearly the same terms as the RBOCs' regulated operations. As explained in more detail in the attached declaration of John Haring and Jeffrey H. Rohlfs, an 11.25% rate of return is appropriate for a regulated utility "where economic risks [are] minimal due to the presence of credible regulatory guarantees of a reasonable opportunity to recover the costs of invested capital, including a fair return." Declaration of John Haring and Jeffrey H. Rohlfs, 1 ("Haring/Rohlfs Decl.") (attached hereto as Exhibit 1). For independent payphone providers, by contrast, "there are no regulatory guarantees of a reasonable opportunity to recover costs," and "the industry is, from an economic perspective, substantially riskier than a regulated public utility." *Id.* Because the independent payphone industry carries greater investment risks, "higher economic returns are necessary to attract investment capital resources and lead firms to deploy capital equipment for the provision of payphone services." *Id.*

APCC pointed out in its *Second R&O* Reply Comments, "rates of 15%-18% are more realistic" for the rate of return that independent payphone providers must meet in order to attract capital. APCC *Second R&O* Reply Comments (Sept. 10, 1997), 15. Messrs. Haring and Rohlfs point out that the 15% - 18% range "reside[s] at the low end of the range of returns sufficient to ensure the maintenance of competitive

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[6] In any event, the Commission cannot set the rate of return for the entire payphone industry based on the rate of return for the RBOCs' regulated operations.

investment incentives in the payphone business." Haring/Rohlfs Decl., 2. According to Messrs. Haring and Rohlfs, "firms contemplating investments in the payphone business are actually likely to utilize significantly higher discount rates than returns in [the 15%-18%] range and substantially greater than 11.25 percent." *Id.*

This view is supported by the former chief of the Common Carrier Bureau, Gerald Brock, who has stated that the appropriate discount rates for competitive telecommunications businesses, such as independent payphone providers, would be "very high." *Id.* According to Mr. Brock, "the idea of using an 11 percent discount rate is all wrong. You're talking about a 20-25 percent discount rate . . . . I don't think anyone should sit here today and think that a private firm in competition is going to use an 11 percent discount rate." *Id.*

C. The *Third R&O* Understated the Cost of Payphone Maintenance by Improperly Subtracting Out the Cost of Certain Non-coin Related Service Visits

The Commission's third error in calculating the dial-around amount is in its calculation of the maintenance costs associated with dial-around calls. The Commission found that "Peoples Telephone reports that 38% of its maintenance visits were strictly coin related." *Third R&O*, ¶ 177 (citing Peoples' *Second R&O* Comments (Aug. 26, 1997), 13. The Commission therefore subtracted 38% ($11.59) from its weighted average estimate of maintenance costs of $30.49[7] to "reflect coin collection

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[7] Based on the SBC estimate of $24.37 and Peoples' estimate of $41.66 weighted to reflect LEC/independent distribution of payphones.

costs and costs associated with maintenance of coin payphones." The Commission thus arrived at $18.90 per payphone per month in maintenance costs. *Third R&O*, ¶ 177.

The Commission, however, mischaracterized the data supplied by Peoples. According to Peoples, over a six-month period, its maintenance personnel made a total of 679,265 service visits to its payphones. Peoples *Second R&O* Comments (Aug. 26, 1997), 13. Of these visits, 200,591 were made to collect coins, and an additional 56,157 visits were made to repair the payphone while the service personnel at the same time also collected any coins in the box. *Id.* The 38% figure for coin-related maintenance visits was arrived at by adding together the 200,591 coin collection visits and the 56,157 repair plus coin collection visits, and dividing by the total number of visits (200,591 + 56,157 / 679,256). The 56,157 repair plus coin collection visits, however, should not have been excluded because they would have occurred even if there were no coins to collect. Dividing, then, only the 200,591 coin collection visits by the total of 697,265 service visits yields a figure of 29% of visits due to coin collection. Subtracting out 29% of $30.49 ($8.85) yields $21.64 per payphone per month for maintenance, as opposed to the $18.9 figure used by the Commission. That $21.64 figure more accurately reflects the maintenance costs associated with dial-around calls.

II. THE COMMISSION ERRED IN NOT REQUIRING IXCs TO IMPLEMENT TARGETED BLOCKING CAPABILITY

In the *Third R&O*, the Commission departed from its prior market-based approach to dial-around compensation under which the default dial-around compensation amount for a particular payphone was the price of a local coin call from

that payphone. That market-based approach has been the Commission's preferred approach to ensuring fair compensation since the beginning of this proceeding. As the Commission stated in the *First R&O*: "We conclude that, once competitive market conditions exist, the most appropriate way to ensure that PSPs receive fair compensation for each call is to let the market set the price for individual calls originated on payphones." *First R&O*, ¶ 49. In the context of dial-around compensation, the Commission explicitly "define[d] 'fair compensation' . . . as where there is a willing seller and a willing buyer at a price agreeable to both." *Id.*, ¶ 51. The Commission recognized, however, that the inability to track calls accurately prevented it from moving immediately to a market-based approach to dial-around compensation. *Id.* ¶¶ 5, 53. The Commission declared its intention to eliminate the impediments and move as soon as possible to a market-based approach:

> [W]e recognize that a transition period is necessary to eliminate the effects of some long-standing barriers to full competition in the payphone market. For this reason, we will continue for a limited time to regulate certain aspects of the payphone market, but only until such time as the market evolves to erase these sources of market distortions.

First R&O, ¶ 2.

The Commission abandoned the market-based approach in the *Third R&O* not because it felt that the approach was no longer correct as a policy matter but because it found that the enabling technology—targeted call blocking—was not in place. The Commission concluded that "the present ability of carriers to block is not sufficiently developed to ensure that allowing the default rate to float with the PSP's

local coin rate will necessarily result in a compensation level that is 'fair,' as contemplated by the statute." *Third R&O*, ¶ 12. The Commission found that targeted call blocking is critical to a market-based approach because, if payphone providers are permitted as sellers to set the price of a dial-around call, then the IXCs, as buyers, must have "some ability to reject a call based upon the compensation amount for the call." *Third R&O*, ¶ 64. Otherwise, the seller would be able to unilaterally set the price for the transaction.

The Commission itself recognized the importance of targeted call blocking to a market-based approach, saying that "[w]e believe that targeted call blocking ultimately will play a significant role in bridging the gap between Congress's and the Commission's goal of a deregulatory solution and the present state of payphone telephony." *Third R&O*, ¶ 16. The Commission, however, failed to take the critical step necessary to reach that goal. While the Commission noted that "IXCs currently possess the technology and receive the coding digits necessary to implement a targeted call blocking mechanism," *id.*, the Commission failed to order the IXCs to implement such a solution.

Instead, the Commission found that "the lack of targeted call blocking is a temporary phenomenon," *id.*, ¶ 67, and relied on its expectation that "the parties that are the principal economic beneficiaries of the payphone market – the payphone providers, the IXCs, and the subscribers to toll-free lines," *id.*, would move on their own to develop targeted call blocking. The Commission thus took a "wait-and-see" approach, setting January 1, 2001 as the date by which it hopes IXCs will implement targeted call blocking. By that date, the Commission believes "the parties will have had

the opportunity to resolve the impediments that currently inhibit the ability of payphone owners and carriers to negotiate fair compensation for dial-around calls." *Id.*, ¶ 18.

The IXCs, however, have no incentive to develop targeted call blocking. Currently, market rates for local coin calls are $.35, or more than 45% higher than the current dial-around compensation rate of $.24. The IXCs thus do not stand to gain from a move to a market-based approach. There is therefore no reason to believe that the carriers will go forward with implementing targeted call blocking absent an express Commission directive to do so.

If the Commission believes that targeted call blocking will open the way to the market-based approach to dial-around compensation that the Commission believes is correct, then the Commission must order the IXCs to implement the necessary technology as soon as possible. As the Commission found, "it will require a significant amount of time for IXCs to fully implement and deploy the necessary technologies." *Id.*, ¶ 18. The IXCs will not even begin the implementation process until they are ordered to do so. Thus, the longer the Commission delays in ordering targeted call blocking, the longer it will be before dial-around compensation can move to the market-based approach that the Commission has identified as the preferred approach.

III. THE COMMISSION ERRED IN REQUIRING PAYPHONE PROVIDERS TO REFUND A PORTION OF THE DIAL-AROUND REVENUE FOR THE PERIOD FROM OCTOBER 7, 1997 TO THE EFFECTIVE DATE OF THE *THIRD R&O*

The Commission should also reconsider its decision to order a true-up of the dial-around compensation amount paid to payphone providers during the period

from October 1, 1997 to the effective date of the *Third R&O*. In cases where retroactive modification of rates is permissible, the Commission must decide whether to impose such retroactive remedies based on the equities underlying each case:

> [T]he [D.C. Circuit has] held that the standard of review of an agency refund order is *whether the agency decision is "equitable in the circumstances of this litigation."* The stress upon "equitable considerations," indicates that, while the agency has a duty to consider the relevant factors in making a refund decision and enjoys a broad discretion in weighing these factors, the precise manner in which these general principles should be applied by a reviewing court depends upon, as is traditional in cases sounding in equity, the facts of the particular case.

Las Cruces TV Cable v. FCC, 645 F.2d 1041, 1047-48 (D.C. Cir. 1981) (quoting *Wisconsin Elec. Power Co. v. FERC*, 602 F.2d 452, 457 (D.C. Cir. 1979)). As the court noted in remanding the proceeding to the Commission, the "Commission itself has acknowledged that it has the authority to adjust the compensation rate retroactively, '*should the equities so dictate.*'" *MCI v. FCC*, 143 F.3d 606, 609 (D.C. Cir. 1998) (emphasis added) (citations omitted).

In *Towns of Concord*, the D.C. Circuit clarified that there is no presumption in favor of retroactive refunds or surcharges and, in fact, that equity generally disfavors the imposition of retroactive refunds:

> Customer refunds are a form of equitable relief, akin to restitution, and the general rule is that agencies should order restitution *only when "money was obtained in such circumstances that the possessor will give offense to equity and good conscience if permitted to retain it."*

Towns of Concord v. FERC, 955 F.2d 67, 75 (D.C. Cir. 1991) (emphasis added) (quoting *Atlantic Coast Line R.R. v. Florida*, 295 U.S. 301, 309 (1935)). The Commission recently adopted the *Towns of Concord* decision, holding that "[j]ust as FERC has discretion to

consider matters of equity in ordering refunds under the Federal Power Act, we have discretion to consider matters of equity under the Communications Act." *In the Matter of Investigation of Special Access Tariffs of Local Exch. Carriers*, 6 Comm. Reg. 555, 607 (1997) (citing *Towns of Concord*, 955 F.2d at 72; *Las Cruces*, 645 F.2d at 1046-48).

Here, however, the Commission ordered the true-up without first engaging in a balancing of the equities. Had the Commission evaluated the equities, it would have concluded that requiring a refund was inappropriate.

The current proceeding is an outgrowth of Docket No. 91-35, in which the Commission erroneously failed to award independent PSPs compensation for subscriber 800 calls. In that initial payphone compensation decision, the Commission erred in interpreting TOCSIA's mandate to "consider the need to prescribe compensation" for independent PSPs as applicable only to access code calls, not to subscriber 800 calls. After several years of delay (granted at the behest of IXCs and the Commission based on allegedly related reconsideration proceedings), the court of appeals finally heard APCC's appeal of the Commission's ruling, and overturned it, holding that Section 226 did in fact authorize the Commission to prescribe subscriber 800 compensation. Congress then confirmed, by enacting Section 276, that PSPs were in fact entitled to compensation for subscriber 800 calls. *Florida Pub. Telecomms. Assoc. v. FCC*, 54 F.3d 857 (D.C. Cir. 1995) ("*FPTA*"). The Commission folded its proceeding on remand of *FPTA* into the present proceeding on Section 276. APCC then requested that the Commission take a modest step to recognize independent PSPs' entitlement to compensation under *FPTA* by making the interim compensation in this

proceeding retroactive at least to the date of the Public Notice initiating this proceeding. The Commission rejected this request, stating only that compensation was being provided "as soon as practicable." *First R&O*, ¶ 126.

Given the Commission's decision in the *Third R&O* to reduce further the dial-around compensation amount, the IXCs can complain only that they paid too much compensation for, at most, about one year. Independent PSPs were deprived of *any* compensation for subscriber 800 calls (about 70% of compensable coinless calls) for *more than four years.* It cannot be equitable to require PSPs to give back any of the compensation they have received to date, when that compensation barely begins to make up for four years' worth of uncompensated subscriber 800 calls.

By contrast, a retroactive refund would bestow a windfall on the IXCs. Not only have the IXCs passed on the full cost of dial-around compensation to consumers through direct surcharges, the IXCs have also used a variety of other means to recover their costs that, in the aggregate, have resulted in a massive *over*-recovery for the IXCs'. Thus, rather than having been harmed by being required to pay dial-around compensation, the IXCs have actually benefited, by turning dial-around calls into a profit center.

The IXCs began passing on their dial-around costs as surcharges in December 1996. In December 1996, for example, Sprint revised its FCC Tariff No. 2 to add a $.15 per call Payphone Surcharge for "all Originating payphone traffic including FONCARD traffic, toll free switched and dedicated services traffic, Prepaid card service traffic, and 10CPA-0 Plus Dial-around service traffic" effective December 1,

1996.[8] Effective April 1, 1997, this charge jumped to $.35.[9] The other major carriers have put equivalent surcharges in place. *See* RBOC Coalition *ex parte* letter from Marie Breslin to Magalie Roman Salas (March 11, 1998), The Toll-Free Truth: Long Distance Companies Overcharge for Payphone Calls, 1, 3 ("Toll-Free Truth") (pertinent pages attached hereto as Exhibit 2). The amount of these surcharges often exceeded the $.24 rate in effect during the period in question. *See* APCC *ex parte* letter from Albert H. Kramer to Magalie Roman Salas (March 16, 1998), History of Payphone Compensation, 19 ("History of Payphone Compensation") (pertinent pages attached hereto as Exhibit 3). Thus, there is every reason to believe that the surcharges alone *more* than fully compensated the IXCs for their dial-around costs during the period in question.

On top of the surcharges, however, the IXCs, most notably AT&T, Sprint, and MCI have raised their rates for subscriber 800 and some interstate and international services in direct response to their dial-around compensation obligations. History of Payphone Compensation at 17; Toll-Free Truth at 1-6. AT&T, for example, increased interstate 800 rates by 3% in February 1997, allegedly to recover increased payphone costs.[10] MCI spread "increase[d] rates as a result of the Payphone Recovery Order" across some 21 categories of service, none of them seemingly related to payphone

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[8] Sprint has estimated that its total monthly cost of paying its $4.97 share of the monthly $45.85 per payphone interim compensation to PSPs is $2.5 million, and it was recovering this new cost through the $.15 surcharge. *See* APCC's *Second R&O* Comments (Aug. 26, 1997), Attachment 5.

[9] *See id.*, Attachment 7.

[10] *See id.*, Attachment 8.

services. History of Payphone Compensation, 17. *See also* Toll-Free Truth, 6. These rate increases were over and above direct surcharges. According to a study performed by Frost & Sullivan, based on public information provided by AT&T, AT&T's rate increases *alone* totaled some $642 million in 1997. *See* RBOC Coalition *ex parte* letter from Marie Breslin to Magalie Roman Salas (March 11, 1998) (attaching Frost & Sullivan study re AT&T rate increases).

In addition to recovery from end users, the IXCs also benefited from $250,000,000 annually in payphone-specific reductions in interstate access charges paid to local exchange carriers ("LECs") as a result of the Commission's rules terminating all subsidies for the LECs' payphone operations. History of Payphone Compensation, 17. Substantial additional subsidies were also terminated at the state level. *Id.*

The IXCs have also received substantial cost savings as the result of the shift away from commissionable 0+ calls. From 1993 to 1997, the number of 0+ calls from the average payphone fell from 51 to 16 calls per month. *See* RBOC Coalition *ex parte* letter from Marie Breslin to Magalie Roman Salas (March 11, 1998) (attaching Frost & Sullivan study re IXC of cost savings). This 69% reduction has dramatically lowered the IXCs' payments to PSPs. The IXCs' total savings are approximately $372 million. *Id.*

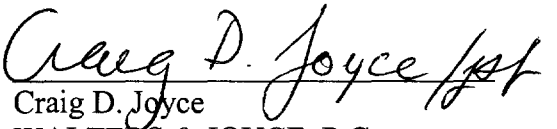
The IXCs have not passed to their customers on any portion of their cost savings from the reductions in access charges and commissionable 0+ calls. Thus, even if the surcharges and rate increases taken together merely resulted in the IXCs covering their costs—which is not the case—the IXCs have actually over-recovered by *at least*

$622,000,000 per year in cost savings alone. When the excess surcharges and rate increases are factored in, it becomes apparent that the IXCs have had *at least* a double recovery of their costs. In light of this, the Commission cannot find that a balancing of the equities permits the IXCs to receive a refund and thus increase their already inordinate over-recovery.

CONCLUSION

The Commission should partially reconsider the *Third R&O* as discussed above.

Respectfully submitted,



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Dated: April 21, 1999

EXHIBIT 1

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Declaration of John Haring and Jeffrey H. Rohlfs

Our names are John Haring and Jeffrey H. Rohlfs. We are principals in Strategic Policy Research, an economics and telecommunications policy consulting firm located in Bethesda, Maryland. Dr. Haring formerly served as Chief Economist of the FCC and as Chief of the Commission's Office of Plans and Policy. Dr. Rohlfs was formerly Head of Economic Modeling Research at Bell Laboratories. We have earlier filed several reports and comments in the Commission's various payphone proceedings on behalf of BellSouth and the APCC, respectively.

The APCC has asked us to comment on the FCC's utilization of an 11.25 percent return in calculating an appropriate rate for per-call payphone compensation. It is our professional opinion that an 11.25 percent return substantially understates the return that is required to induce voluntary investment of capital funds in the provision of payphone service in a competitive market. In basing compensation to produce an 11.25 percent return, the Commission will be establishing a rate that will fail to ensure an economically adequate return and, in consequence, can expect that resources deployed for provision of payphone service will shrink with a resultant loss of service to the consuming public.

An 11.25 percent return is a "utility" type return that could only be suitable in an economic environment where economic risks were minimal due to the presence of credible regulatory guarantees of a reasonable opportunity to recover the costs of invested capital, including a fair return. The problem with utilizing 11.25 percent as a benchmark for setting per-call payphone compensation is that the payphone industry is not a regulated public utility monopoly. It is rather, as has been repeatedly demonstrated in the record of the Commission's proceedings, a competitively organized industry with open entry conditions, a general absence of barriers to entry and a large number of competing firms.

Because the industry is competitively organized and there are no regulatory guarantees of a reasonable opportunity to recover costs, the industry is, from an economic perspective, substantially riskier than a regulated public utility with legal barriers to entry. Because the industry carries greater investment risks, higher economic returns are necessary to attract investment capital resources and lead firms to deploy capital equipment for provision of payphone services. Failure to permit returns sufficient to overcome investors' reticence over risks will lead to capital starvation and artificially

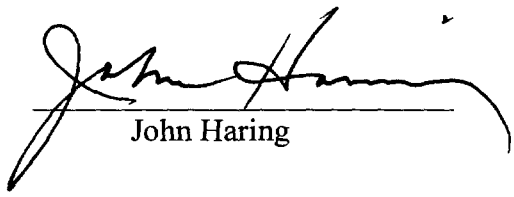
restrict the amount of capital deployed to the industry compared to the amount that would be invested were returns permitted to compensate fully for any attendant risks.

We understand that the APCC has previously remarked that returns in the range of 15-18 percent would more adequately compensate for investment risks in the payphone business. In our view, returns of this magnitude likely reside at the low end of the range of returns sufficient to ensure the maintenance of competitive investment incentives in the payphone business (*i.e.*, incentives commensurate with deployment of capital resources given the risks involved). We believe firms contemplating investments in the payphone business are actually likely to utilize significantly higher discount rates than returns in this range and substantially greater than 11.25 percent.

A few years ago at the Commission's *Economics of Interconnection Panel Discussion Forum*, Gerald Brock, former Chief of the FCC's Common Carrier Bureau and a leading telecom industry expert, stated his view that appropriate discount rates for competitive telecom ventures would be "very high" (pp. 33-34):

> [I]n calculating TSLRIC, the idea of using an 11 percent discount rate is all wrong. You're talking about a 20-25 percent discount rate....I don't think anyone should sit here today and think that a private firm in competition is going to use an 11 percent discount rate.

Our view is the same. An 11.25 percent return is way off the mark and much too low. Compensation based on such an understated benchmark return will likely restrict the flow of funds into the business and limit the capacity deployed.



John Haring

Jeffrey H. Rohlfs